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C O N F I D E N T I A L SECTION 01 OF 05 MOSCOW 005231

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DEPT FOR EUR/RUS, FOR EEB/ESC/IEC GALLOGLY AND WRIGHT
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E.O. 12958: DECL: 11/01/2027
TAGS: EPET ENRG ECON PREL RS
SUBJECT: RUSSIA'S NORTH-SOUTH ENERGY STRATEGY: A KNIFE, A
HAMMER, OR A BAND-AID?

REF: A. MOSCOW 875

¶B. ANKARA 2491
¶C. LONDON 3999
¶D. BRUSSELS 3195
¶E. KYIV 2671
¶F. MOSCOW 5069
¶G. KYIV 2611
¶H. MOSCOW 4691
¶I. SOFIA 1073
¶J. MOSCOW 4088
¶K. BAGHDAD 3254
¶L. MOSCOW 5162
¶M. TBILISI 2657
¶N. BAKU 1227
¶O. BUCHAREST 1205
¶P. SOFIA 1240

Classified By: Ambassador William J. Burns for Reasons 1.4 (b/d).

¶1. (C) SUMMARY. Russian activism in recent years to strengthen the "north-south" energy corridor suggests an intention to slice through the conceptual "east-west" corridor, to reassert Central Asia's dependence on Russian energy routes, and to repair Russia's own fumbling gas balance. Russia appears to be using several tools to build a stronger north-south corridor: money; Russia's existing and new pipeline routes; solidarity with Iran on energy issues; and aggressive counter-measures against "east-west"-oriented transportation routes.

¶2. (C) However, we doubt Russia can succeed in this effort. Success would require an unlikely combination of subservience by the Central Asian countries, lethargic pursuit of east-west routes by the West, Chinese apathy, and a reliable Iranian partner. Everyone in the region understands the game so there is little element of surprise left for Russia to use. And, perhaps most importantly, Russia has squandered the key element of trust in nearly all its energy relationships in Eurasia.

¶3. (C) In our view, Russia will remain dependent on, more than controlling of, Central Asian gas and will continue to play an aggressive game of catch-up with emerging alternative routes. On the oil front, Russia has more cards to play but, with the Baku-Tbilisi-Ceyhan (BTC) line in place and cross-Caspian shipments looming, the horse is already out of the barn. Against the backdrop of these Russian weaknesses, the West has an opportunity to put the burden on Russia -- via proposals to cooperate but not dominate -- to declare whether Russia is only interested in control, or can sometimes see its self-interest in playing by everyone else's rules. END SUMMARY.

DOMINATING CENTRAL ASIA IS NOT SO EASY

¶4. (C) Russia has been reminded recently that when it comes to energy, Central Asia and the Caucasus are not the roll-overs they once might have been. Russia's activism in the last two years to strengthen the "north-south" energy corridor has been notable, but mostly reactive. Russia has increased prices paid to Kazakhstan and Turkmenistan for gas, driven by the emergence of China in the region pulling resources eastward, by continued talk of a trans-Caspian corridor, and, perhaps most importantly, by Russia's primary need for this gas (ref A).

¶5. (C) Yet the Central Asian countries remain interested in independence and sustainable sovereignty and are increasingly astute in their

pursuit. Kazakhstan's Nazarbayev has managed to appease Russia on energy while not precluding his own options. Turkmen president Berdymuhamedov's relatively bold moves to reach out in all directions attest to a similar calculus, as demonstrated most emphatically by his gas production and pipeline deal with China. That both countries signed onto the May 2007 gas pipeline deal with Russia without negating alternatives was an acknowledgment of geographical reality, but the deal also demonstrated that Kazakhs and Turkmen understand the need for alternatives to help secure the highest price through the Russian route.

EUROPE AWAKENING? TESTS FOR RUSSIA

¶6. (C) As the Chiefs of Missions conference in Istanbul in September (ref B) concluded, reaffirming Europe's interest in the sovereignty and sustainability of the FSU countries and the New Europe countries is a prerequisite to securing EU activism on alternative energy corridors originating from or through these countries. Perhaps ironically, Russia's own energy mistakes and diplomatic bludgeoning over the last two years appear to be driving a more active European consideration of energy realities in the region.

¶7. (C) Recent evidence (for example, refs C and D) suggests Europe will engage more strongly, presenting Russia with the challenge of taking on more adversaries than bargained for or finding ways to cooperate. South Stream and Blue Stream-2 are clearly reactions to Nabucco and other evolving southern corridor lines. But Russia is also considering its options should Nabucco go ahead, providing the opening for Europe to force Russia to reveal its intentions at a time when Europe is rigorously reviewing its tolerance of Russia's

ambitions in the European energy sector.

¶8. (C) Indeed, Russia's initial reactions to the draft competition regulations the EU revealed on September 19 ranged from stunned to indignant, and the GOR is still trying to figure out its approach to this new European resolve. This presents an opportunity for the EU to test Russia's willingness to play by the rules, perhaps with Nabucco as an early case. Gazprom Chairman (and First Deputy Prime Minister) Dmitriy Medvedyev's recent trial balloon about eliminating middlemen in the Russia-Ukraine gas trade (refs E, F and G) may provide another opportunity to foster more rules-based and transparent behavior on the foundation of economic reality - in this case, the reality that increasing gas prices everywhere makes middlemen too expensive.

CROSS-CASPIAN OIL PROBABLY A GIVEN

¶9. (C) With excess capacity in its own oil pipeline system, Russia should in principle have great clout in dominating Central Asian (primarily Kazakhstani) oil flows. Instead, Russia failed to expand the Atyrau-Samara line. And after pushing Caspian Pipeline Consortium (CPC) negotiations to the breaking point, Russia appears to have been forced partly by Kazakhstani-Azeri progress on cross-Caspian shipments to finally come to an (apparently workable) agreement on CPC expansion (ref H).

¶10. (C) At the same time, for all its attempts to dominate the Burgas-Alexandropolous pipeline bypass of the Bosporus, a pipeline Russia views as a CPC extension, Russia has punted the burden of filling

the pipe onto Bulgaria and Greece (ref I) while retaining a majority interest, a business model that could drive Kazakhstan to cross-Caspian routes as an alternative. Meanwhile, the success of the BTC oil pipeline was largely unexpected in Russia and has brought some urgency to preventing expansion of this corridor, but Russia has accepted (ref J) that cross-Caspian tanker traffic will happen.

CROSS-CASPIAN GAS STILL UP FOR GRABS, BUT
DIFFICULTIES ON EVERY SHORE

¶11. (C) Russia may have had some success delaying Kazakhstan's consideration of a cross-Caspian gas pipeline but at the cost of paying substantially higher prices to Kazakhstan, and Russia has not been able to kill the idea of a cross-Caspian route. Berdymuhamedov famously reserved the right to examine cross-Caspian options immediately after signing the May pipeline agreement with Russia and Kazakhstan. Russia's own companies such as Lukoil and TNK-BP have joined the parade of energy companies courting Turkmenistan to explore for oil and gas and have told us, as have western firms, that they would examine all transportation routes that are commercially sensible.

¶12. (C) Russia may be testing Iran as a partner for dominating a north-south flow for Central Asian gas, but an examination of prospects for such an alliance would suggest that common Russo-Iranian energy interests could well be offset by lack of follow-through and trust. The recent summit of Caspian states could be interpreted as reaffirmation of common interests among the five littoral states, but the fact that Putin and Ahmadinejad also used the occasion to discuss

cross-Caspian pipelines suggests some anxiety.

¶13. (C) Russia and Iran clearly have a mutual interest in preventing the cross-Caspian flow of gas and they both win if either causes a north-south flow. But news reports after the summit that a deputy foreign minister of Azerbaijan refuted Putin's insistence that all five states must agree to a pipeline suggests that plucky self-interest remains the watchword among the Caspian states rather than solidarity. Recent rumors that Gazprom may participate in a major way in the Iran-India gas pipeline also seems unlikely given Gazprom's squeezed financial situation.

¶14. (C) Russia and Iran undoubtedly recognize the latent power that collusion on gas supplies could give them over prices, but there is little record of trust. Most analysts in Moscow believe that Russia would never formally join a "gas OPEC," even if it would certainly consider ways of achieving some of the clout such an organization might afford. Finally, Iran is anything but a reliable partner for Russia and it would be difficult to imagine a rosy relationship on mutual energy interests being completely carved out from the myriad troubling geopolitical issues facing the bilateral relationship.

THE IRAQ FACTOR

¶15. (C) A final consideration is Iraqi gas. Russian companies have examined Iraqi prospects and must know that Iraqi gas will be searching for European markets sooner or later. Western industry contacts in Moscow who have undertaken negotiations with all the Iraqi factions tell us that Iraq could

be exporting 10-12 bcm at a minimum into Nabucco within 3-4 years of signing, provided the political support of the U.S. and Baghdad is forthcoming.

¶16. (C) As ref K details, there is probably more where that came from. Even if Russia senses a window of opportunity to control or deny a "southern corridor" before Iraqi exports come online, it probably concurrently feels too weak to do anything about Iraqi gas. That said, Lukoil and others are increasingly frustrated at their inability to pin down deals such as West Qurna, so that their role as potential champions of Iraq's oil and gas development remains underexploited.

BEAST TO THE EAST: NEW FACTOR PULLING AGAINST RUSSIA
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¶17. (C) China's thrust into the region means diversion of resources along an eastern branch of the east-west corridor at Russia's expense. Some analysts here believe Russia was almost as surprised by the Kazakhstan-China oil pipeline as they were by BTC. Russia may have thought it had locked in Kazakhstani gas by upping the price and getting Nazarbayev to cease and desist his pursuit of a cross-Caspian gas line, but instead Kazakhstan turned to China as a potential gas export route. Turkmenistan's deal for a gas pipeline to China certainly has some Russian officials wringing their hands.

¶18. (C) Some in the Russian elite fear that China could conceivably dominate the "great game" in Central Asia and in any Pacific energy strategy

Russia might develop (ref L), yet Russia has done almost as much harm to itself on the eastern side of Eurasia as it has on the western side over the past few years. Russia has achieved nothing in 18 months of talking with the Chinese on bilateral gas trade since Putin visited Beijing in March 2006 and struck two agreements on building gas pipelines. Gazprom's takeover of the Kovykta project amplified Chinese and South Korean reticence to place too much trust in Russian energy and drove them to seek alternatives including the Caspian countries. Russia's clumsy attempts to play China and Japan off each other on the East Siberia-Pacific Ocean oil pipeline jaded the Asian countries towards Russia, as our Japanese colleagues have confided to us.

¶19. (C) Looking forward, China could be considered in some respects a pacesetter for, and an ally of, those pursuing the east-west corridor. For where once Russia may have thought it could rekindle the Soviet-era reality that Central Asian molecules went to mother Russia first before transiting onwards to markets, Russia now finds itself racing against Central Asia for the Chinese market) and against China for influence in Central Asia. And while Gazprom may feel confident in its newfound control of the East Siberian gas development and export plan, the Kremlin's push to the east was largely reactive -- to the Russian private sector's preceding efforts to cut such export deals itself and to China's activism in Central Asian energy.

CONCLUSION

¶20. (C) Russia can be counted on to aggressively pursue its interests, which it perceives as thwarting the east-west energy corridor, where it can. But its leverage is declining in Central Asia and the Caucasus as China enters the scene and as

dependency on Russia for supply or transit declines in relative terms (e.g., refs M and N). Russia's leverage is perhaps growing in countries such as Bulgaria or Romania (refs O and P) that are nexuses where the southern energy corridor is colliding with Russia's interests. But Russia's poor track record of energy diplomacy and trust-building throughout Eurasia has left it with few places to attempt genuine strategic alliances, leaving Russia to peddle influence the old fashioned way - through ad-hoc marriages of convenience and likely through graft as well. In that respect, Russia's north-south thrust is less a weapon or a political bludgeon than a reaction to injury (band-aid), whether self-inflicted or not.

¶21. (C) Against the backdrop of these fundamental weaknesses, deft diplomacy could harness Russia's ambitions by posing it with a challenge - to signal to the world, at a time when most are wary and anxious of Russia's energy throw-weight, whether Russia is interested only in control or is ready to cooperate. While the Russian elite's often groundless (and boundless) sense of aggrievement will push the leadership to see neo-containment behind every western action on the energy front, the leadership has demonstrated, occasionally and fitfully, that pragmatic self-interest can sometimes win out.

¶22. (C) That means it is worth exploring whether Russia can be brought into constructive relationships -- which in turn means using our leverage carefully and creatively. The EU is

doing that with new regulatory proposals, and could do the same via a well-timed invitation into Nabucco and carrying through on the idea of eliminating middlemen in the Ukrainian gas trade. Central Asia is doing that by introducing China into the equation. China itself is doing that by courting Russian gas while securing alternatives in Central Asia and elsewhere to force Russia into compromise on price. We presumably can have influence in all these developments as well as by accelerating Iraqi gas entering the southern corridor. All of these could rope Russia in to being a senior, but not dominant, part of Eurasian energy stability, or they will smoke Russia out - to Russia's own detriment.
Burns